Katten
Katten Muchin Rosenman Cornish LLP

Client Advisory

Venture Capital Documentation—US and UK Approaches

28 January 2009

Introduction

The purpose of this advisory is to highlight the differences between US and UK approaches to documenting venture capital transactions.

A venture capital transaction, where an investor or a group of investors privately acquires shares in a company, is essentially the same transaction in any jurisdiction. Nevertheless, the US and UK styles of documentation can be different in significant respects.

Venture capital transactions can vary depending on the type of investor, whether the investor is acquiring debt or equity (or a combination of both) and the stage of development of the company or business. In this advisory, we will address venture capital transactions involving equity investments.

A typical venture capital transaction (whether it be an investment into a US or a UK company) involves the following principal elements:

- The investor or investors acquire equity in a private company in return for cash.
- Investors typically receive a class of preferred or preference shares giving a priority right to receive payments in the event the company is sold, liquidated or wound-up, and, in many cases, a cumulative dividend.
- The company and, in some cases, its key management or founders give representations, warranties or indemnities to the investors about the company and its business.
- The investors are given various rights by the company, including rights to receive financial and other information relating to the company.
- The investors are given board membership or representation rights.
- The rights of the parties on an "exit", particularly an initial public offering or sale of the company, are defined.

A number of key differences between the form of a typical US and UK venture capital transaction include:

- style of documentation and terminology used;
- corporate differences;
- representations and warranties (and exceptions or "disclosure" against these); and
- investor protections.

Style of Documentation and Terminology Used

A typical US venture capital transaction involves the following key documents:

- **The Stock Purchase Agreement.** This agreement includes the purchase or subscription of shares/stock by the investors and includes the arrangements for the closing of the transaction. This agreement also usually includes terms requiring the company to provide the investors with information on and access to its business. At the back of the agreement is usually a schedule of exceptions (or "disclosures") to the representation and warranties made by the parties.

- **The Stockholders' Agreement.** This agreement includes pre-emption rights, rights of first refusal, co-sale and drag-along rights, and often a vesting schedule by which the founders would forfeit shares in the event of their departure from the company.

- **The Certificate of Incorporation/Certificate of Designation.** The Certificate of Incorporation is the constitutional document of the company. When an investor is to purchase/subscribe for preferred stock, all of the terms of the preferred stock, including its special rights, such as anti-dilution protection and liquidation preferences, must be set forth in the Certificate of Incorporation. This is accomplished by amending the Certificate of Incorporation, restating the Certificate of Incorporation, or creating a Certificate of Designation if the Certificate of Incorporation permits previously undesignated shares of preferred stock to be issued with the specific rights and preferences.

- **By-Laws/Operating Agreement.** The by-laws, together with the Certificate of Incorporation, regulate the internal governance of the company. An investor may sometimes require that these be changed if they contain corporate governance procedures deemed unsuitable for the company.

- **Registration Rights Agreement.** Securities sold in the US generally cannot be freely resold to the public unless registered under the Securities Act of 1933. The Registration Rights Agreement allows the investor to demand the company to register shares owned by the investor (typically only the common shares issuable upon conversion of preferred shares) and to include, or piggyback, their shares on any proposed registration by the company (see further below).

- **Employment/Service Contracts.** Investors frequently require key executives of the company to enter into new service or employment contracts in a form approved by the investors. These will typically set out in detail the terms and conditions of employment of the executive and may impose restrictive covenants after his or her departure from the company (see further below).

In the UK , the following documents are required:

- **"Investment Agreement" or "Subscription and Shareholders' Agreement".** This agreement, regardless of the name used, is a combination of the US Stock Purchase Agreement, By-Laws and the Stockholders' Agreement. As such, it includes the mechanism for the subscription of shares and sets out the investor's rights.

- **Articles of Association.** This document combines the US Certificate of Incorporation and the By-laws. It usually includes share class rights, pre-emption rights on the issue and transfer of shares and provisions dealing with the mechanics of holding board and shareholder meetings.

- **Disclosure Letter.** This is a letter from the company (or its lawyers) to the investor (or its lawyers) that sets out disclosures against, or exceptions from, the warranties given to the investor. This letter is the equivalent of the schedule of exceptions at the back of the US-style Stock Purchase Agreement.

- **Employment/Service Contracts.** Investors in UK-style transactions will also require key executives of the company to enter into new service or employment contracts in a form approved by the investors.

In addition to the differences in the style of documentation, the terminology used in US and UK venture capital transactions also differs. For example, venture capital investors in a US company "purchase stock", while investors in a UK company "subscribe for shares". The choice of terminology is largely dictated by the jurisdiction in which the company is organised and is generally commercially inconsequential.

Corporate Differences

US companies are commonly incorporated in Delaware, which is widely regarded as offering a form of corporation that is flexible in both initial organisation and continuing compliance with corporate governance rules. Delaware also has the most developed body of corporate case law and its courts are particularly expert in dealing with matters of Delaware corporate law. Furthermore, the corporation law of Delaware has the advantage of being widely familiar to legal practitioners across the country.

The US federal securities laws must also be complied with in connection with any offering of securities. Almost all venture capital transactions in the US are completed as private sales, requiring investors in venture capital transactions to have a high net worth as well as a certain level of sophistication.

UK companies are most commonly incorporated under the Companies Acts 1985 and 2006 (as amended) (the "Companies Act"), which regulate the incorporation and operation of companies incorporated in England and Wales. It is relatively quick and easy to establish such a company. Since 1 October 2008, there is no longer any statutory

restriction on a private company providing financial assistance for the acquisition of its shares or those of its private holding company. Financial assistance was previously an issue, for example, where venture capital investors frequently required the company into which they were making an investment to pay their legal and other fees in relation to the investment.

Representations and Warranties

Misrepresentation

UK companies will usually only give warranties, while US companies will give both representations and warranties. The difference can be significant. Under English law, a misrepresentation could allow an investor to rescind the contract. Further, a claim for misrepresentation is a claim in tort instead of contract, and the level and type of damages that can be claimed may be higher (depending on the circumstances of the claim).

Founders

In US-style transactions, the founders of the company do not usually make representations or give warranties. Representations and warranties by founders are more commonplace in UK deals.

Disclosure

Disclosure against warranties and representations is another significant difference. In a typical UK venture capital transaction, warranties are qualified by information provided in a separate disclosure letter, while the equivalent carve-outs in the US-style transactions are provided in schedules at the back of the purchase agreement. The concept is identical: these disclosures are to carve out exceptions from the warranties.

The UK disclosure letter includes both general and specific disclosures against the warranties. General disclosures are usually disclosures of those matters of which the investors are deemed to have public knowledge, such as matters on public record at Companies House and information available through public searches. Specific disclosures are matched to individual warranties, although it is normally agreed that disclosure against one individual warranty is also effective against other warranties to which the disclosure is relevant. The Subscription and Shareholders' Agreement commonly provides that the warrantors will not be liable for any matter which is "fairly" disclosed in the disclosure letter.

In a typical US venture capital transaction, specific disclosures against representations and warranties are listed in schedules at the end of the share purchase agreement. General disclosures, however, are by and large not acceptable to US investors, and thus companies usually cannot avoid liability under a representation or warranty because a key fact was publicly available through some other source.

In typical UK venture capital transactions, a bundle of disclosure documents is also delivered to the investors or their lawyers. These documents are referenced by the specific disclosures in the disclosure letter. Once again, all matters that are fairly disclosed in these documents are typically deemed to be effectively carved out of the warranties. Although equivalent documents are delivered to investors in a typical US venture capital transaction, this is not generally effective to protect the company from liability under the representations and warranties unless these documents are specifically referenced in the disclosure schedules.

Limitations on Liability

In the UK, a number of limitations are given on the liability of the warrantors and indemnities, such as time limits within which claims must be made, caps on liability and minimum financial levels for claims before they can be made. Equivalent limitations are uncommon in a typical US venture capital transaction.

Investor Protections

Differences may exist between typical US and UK venture capital transactions in relation to:

- anti-dilution protection;
- consent rights;
- restrictive covenants;
- board representation;
- share retention rights;
- registration rights; and
- pre-emption rights on issues and sales of shares.

Anti-dilution Protection
An anti-dilution provision protects the shareholder class that has the benefit of it, usually the investor class, from some of the effects of dilution caused by the company issuing securities at less than the subscription price paid by the original investor (a “down round”). Such protection is commonly found in both UK and US venture capital transactions. In the UK, the anti-dilution provision will commonly (although not exclusively) be found in the articles of association, as it is a right that attaches to the relevant class of shares. In the US, provisions would typically be found in the Stockholders’ Agreement.

There are two main types of anti-dilution protection:

- **Weighted average.** Weighted average anti-dilution protection ensures that an investor will not be diluted any further than the investor would have been had the new issuance of shares been made at the same price as the investor had paid. This form of protection is sensitive to the number of shares involved in the subsequent issuance, meaning that an issuance of a relatively small number of shares at a lower price will result in the investor receiving a relatively small number of additional shares in compensation.

- **Full ratchet.** Full ratchet protection provides the investor with the additional number of shares its investment would have purchased at the lower price set in the subsequent issuance. Full ratchet protection is considered relatively punitive in nature because it takes no account of the number of shares being issued at the lower price. If even a single share is issued at a lower price, the investor's holdings will be adjusted so that, in effect, its price per share will be reduced to the lower price. Full ratchet protection may result in an increase in an investor’s percentage ownership of a company.

The mechanism for increasing an investor’s holdings is generally an adjustment to the conversion rate of the preferred/preference shares held by the investor. An exception to these anti-dilution protections is usually made for shares issued pursuant to the exercise of employee options and as consideration for an acquisition.

Consent Rights
Both US and UK venture capital documentation usually contains a list of various actions of the company which require the prior consent of the investors. Such actions include matters such as issuing new shares or changing the constitutional documents of the company. The list will include matters relating to the normal business of the board of directors, including:

- significant changes in nature of the business;
- major acquisitions or disposals;
- capital expenditure or contract commitments in excess of pre-agreed limits;
- changes to the business plan or budget;
- borrowing limits and security packages;
- dividend policy;
- appointment and dismissal of key management;
- material dealings with intellectual property; and
- dealings between the company and its shareholders (except arms’ length dealings in the ordinary course of business).

Restrictive Covenants
Non-competition provisions or restrictive covenants on the activities of a company’s founders or executives are commonly found in UK and US venture capital documents. Investors wish to ensure that, having invested money in a company, the founders or executives do not leave and set up a competing business or poach employees or customers. In the US, in certain jurisdictions such as California (but not New York), restrictive covenants may be considered more difficult to enforce. At a minimum, covenants preventing solicitation of employees, customers and suppliers are commonplace and enforceable in any US jurisdiction.

In the UK, investors often insist on including non-competition provisions and restrictive covenants in the Investment Agreement or Subscription and Shareholders’ Agreement and to replicate them in individual directors’ service contracts (see below). To ensure that the restrictions are enforceable under UK law, the restrictions must be limited in scope and duration.

In UK transactions, investors commonly introduce new employment or service contracts for the founders or key executives that also include restrictive covenants on the activities of these individuals. In contrast with the provisions in the Investment Agreement or the Subscription and Shareholders' Agreement, the covenants in the employment or service contracts run in favour of the company rather than the investors. Separate provisions may be included in the Subscription and Shareholders' Agreement allowing the investors to require the company to enforce these restrictions. Restrictive covenants in employment contracts are typically shorter in duration than those given to the investors in the Investment Agreement or Subscription and Shareholders' Agreement because they are considered more difficult to enforce in an employment contract.

In the US, enforceability of restrictive covenants does not generally vary depending on the agreement in which they are contained.

Board Representation

Investors in both UK and US venture capital transactions typically seek representation on the company's board of directors or observer rights at board meetings. The extent of these rights will usually depend upon the size of the investment, but it may also depend upon the value that the company believes the investor can add through its board participation and other areas (such as introductions to new customers).

Recent changes to English law have affected the duties and obligations of directors of English companies. Investors wishing to appoint directors to boards in the UK should discuss with us those directors and the duties/obligations to which they will be subject on a case-by-case basis.

Share Retention

The management team is often a key component of a business' value, and investors in both US and UK venture capital transactions will usually seek to provide incentives for founders and key executives to remain with the company. Often the investors will require that the founders and key executives relinquish a portion of their share ownership if they leave the company. In UK transactions, often the individuals may be required to relinquish all of their shares under certain circumstances, although this would be less common in a US deal.

The approach to share forfeiture provisions has traditionally been distinct between the US and the UK. US transactions have imposed a vesting schedule that specifies increasing levels of share retention the longer the individual remains with the company. UK-style transactions provide for differing levels of share retention depending on the circumstances under which the individual leaves the company. UK documentation distinguishes between two broad categories of departing individuals: "good leavers" and "bad leavers". Then, within each of these categories, a further distinction is made so that, for example, an employee who resigns voluntarily is treated differently from one who is constructively dismissed, and one who is dismissed without cause is treated more favourably than one dismissed for cause.

Registration Rights

A standard feature of US venture capital transactions is the right of the investors to compel the company to register shares. By creating liquidity, this right provides the investors with an exit from their investment if they desire. There are two basic types of registration rights: demand rights and piggyback rights. Demand rights entitle an investor to compel a company to file a registration statement with the US Securities and Exchange Commission ("SEC") covering the shares held by an investor. Piggyback rights are available where a company is already in the process of filing a registration statement; with these rights, an investor can oblige the company to extend the registration statement to cover the investor's shares. These rights are particularly relevant to US investors, because not only can unregistered shares only be sold to a relatively small number of potential purchasers but also a registration statement filed with the SEC is effective only as to the shares specifically identified; it does not serve to register all the shares of the company. Registration rights are commonly accepted by UK companies/founders from US investors.

By contrast, in any listing of a company's shares on the London Stock Exchange's markets for listed securities (as part of a listing on the official list of the UK Listing Authority), the entire issued share capital of the company is included. Consequently, registration rights are not relevant in the same way for a company seeking to list its shares in London.

Pre-emption Rights on Issues and Sales of Shares

In the UK, the Companies Act requires new issues of shares for cash to be first offered pro rata to existing shareholders. These provisions can be disapplied by shareholders in relation to a specific issue of shares or generally. Modified pre-emption rights are commonly included in the articles of association of a company. These may require that any shares not taken up by existing shareholders be offered again to other existing shareholders before being sold to a non-shareholder.

Because the laws of US jurisdictions may not grant shareholders pre-emption rights automatically, US transaction documentation will generally provide for such rights. The pre-emption rights granted by these provisions in US-style agreements do not differ markedly from typical pre-emption rights in a UK-style transaction.

US and UK venture capital transactions are also alike in typically including rights of first refusal on proposed transfers of shares. Rights of first refusal require a selling shareholder to first offer the shares to the company and/or the other shareholders. Only if the company and/or the other shareholders decline to purchase the shares can the shares be sold to non-shareholders (and even then, they may only be sold for the same price and on the same terms that the shares were offered to the existing shareholders).

Conclusion

There are a number of differences between the documentation of, and rights granted in, venture capital transactions in the US and UK. Differences may be due to the application of local law, but may also be a product of tradition and culture. However, generally the two forms are rapidly converging, leading to a more unified approach to documenting venture capital transactions.

For further information, please contact:

	Direct Dial	Email
Imran Sami, Partner	+44 (0) 20 7776 7658	imran.sami@kattenlaw.co.uk
Sam Tyfield, Partner	+44 (0) 20 7776 7640	sam.tyfield@kattenlaw.co.uk

Published for clients as a source of information. The material contained herein is not to be construed as legal advice or opinion.

CIRCULAR 230 DISCLOSURE: Pursuant to Regulations governing practice before the Internal Revenue Service, any tax advice contained herein is not intended or written to be used and cannot be used by a taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer.

©2009 Katten Muchin Rosenman Cornish LLP. All rights reserved.

Katten

KattenMuchinRosenmanCornish LLP

www.kattenlaw.co.uk

1-3 Frederick's Place • Old Jewry • London EC2R 8AE
+44 (0) 20 7776 7620 tel • +44 (0) 20 7776 7621 fax

Katten Muchin Rosenman Cornish LLP is a Limited Liability Partnership of solicitors and Registered Foreign Lawyers registered in England & Wales, regulated by the Solicitors Regulation Authority, whose registered office is at 1-3 Frederick's Place, Old Jewry, London EC2R 8AE. Registered No. OC312814.

The Members of Katten Muchin Rosenman Cornish LLP (who for convenience only refer to themselves as Partners) are: Martin Cornish, Jack Governale (U.S. lawyer), Arthur W. Hahn (U.S. lawyer), Daniel Huffenus (U.S. lawyer), Andrew MacLaren, Imran Sami, Andrew Turner and Sam Tyfield.

Katten Muchin Rosenman Cornish LLP of England & Wales is associated with Katten Muchin Rosenman LLP, a U.S. Limited Liability Partnership with offices in:

CHARLOTTE CHICAGO IRVING LOS ANGELES NEW YORK PALO ALTO WASHINGTON, DC